United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

ORIGINAL

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

75-6134

B P/S

NED MILLER and FRANCES MILLER,

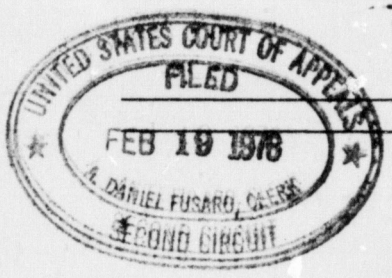
Plaintiffs-Appellants,

-against

THE UNITED STATES OF AMERICA,

Defendant-Appellee.

APPELLANTS' BRIEF



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UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF NEW YORK

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APPELLANTS' BRIEF

Preliminary Statement

This appeal deals with the contention by the Government that in corporate transactions involving corporate funds, that which is not a loan to a stockholder must be a dividend if the stockholder is involved in the fund transfer.

Ned Miller was (and still is) the principal stockholder of two corporations -- Miller Stormguard Corp. ("Stormguard"), and 1680 Coney Island Avenue Realty Corporation ("Realty).

For many years one David Rausch, a C.P.A., worked for Miller as the latter's principal financial officer and advisor. Thus, Rausch not only took care of all corporate financial matters, but also handled the

personal financial affairs of the Millers. Rausch had no authority to sign any corporate checks, except for payroll and a special account to be used when Miller was absent, yet when the events in issue came to light, it was discovered that Rausch had in fact issued some $500,000 of checks passed through the general account in unauthorized transactions, signed by him, many of which occurred in transactions which couldn't be traced.

When Rausch's activities became suspect, an independent audit disclosed his manipulations. Among the many transactions disclosed was one in which Miller had been induced to act as a conduit in transferring some $65,000 from Realty to Stormguard. This transaction, said the I.R.S., was to be treated as a dividend under 26 U.S.C. 316 from Realty to Miller -- although there was no evidence that a dividend was in fact involved. All that existed was a check drawn payable to Miller's order which was endorsed and deposited in the Stormguard account.

The Facts Established At The Trial

In the course of a program of embezzlement, David Rausch, a C.P.A. and the trusted advisor for many years of the plaintiffs and of Stormguard and Realty fraudulently induced Mr. Miller to act as a conduit in transferring $65,000 from Realty to Stormguard (33a). When Rausch's misconduct was discovered (and it included the failure to file tax returns for Realty), Mr. Miller called in an

independent auditor as well as the Internal Revenue Service. An audit was conducted by both the independent auditor and an I.R.S. agent named William Kreps who, on learning of the transferred $65,000 manipulated by Rausch, declared the transferred $65,000 a dividend to Miller although Miller had never received the money nor had any benefit therefrom (37a). Kreps then caused an assessment for tax for the alleged dividend to be levied against Miller, including a substantial interest charge. The tax alone (without interest) amounted to $37,923.75 (9a).* The tax was paid along with the interest claimed by the Government.

Involved in this case is the attempt by the Government to retain the improperly collected assessment made by the I.R.S. agent Kreps who, though a witness for the Government at the trial, was never asked by the Government to justify the assessment or establish the underlying facts in support thereof.

The plaintiffs, Ned and Frances Miller had filed their joint federal income tax return for the year 1957. A second audit of their return, made at plaintiffs' instance on discovery of the Rausch embezzlement, resulted in a determination of a deficiency by the Government auditor in the sum of $37,923.75 (Compl. par. 4.) An assessment

*Parenthetic references are to Appendix unless otherwise noted.

was made and the amount paid in full by the plaintiffs (9a). Subsequently, on May 13, 1966, the plaintiffs filed a claim for refund seeking recovery of this amount. (Compl. par. 5.) After trial their complaint was dismissed on the ground that suit was brought more than two years after November 8, 1966, the date they allegedly filed a Form 2297 [I.R.C., 1954, Sec. 6532 (a) (1)]. On appeal the judgment of dismissal was reversed with a remand for a hearing on the merits (128a et seq.).

This case involves the Government's claim that the transfer of the funds from Realty to Stormguard constituted a dividend to the plaintiff, Ned Miller. The $65,000 in question never was received by appellants, nor did appellants receive any benefit therefrom. Having assessed the tax on such alleged dividend, which tax was paid by the taxpayers, the appellants sued to recover back the collected tax. The Government's original principal defense to the suit for refund was that plaintiffs' suit was not timely commenced.*

On the hard issue of whether the withdrawal of

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*The district court sustained the Government's contention and was then reversed by the Court of Appeals. (see 137a). Ultimately the district court heard the "new trial" merely on an argument, deciding the case on the original trial transcript. Neither side offered any new or additional evidence.

$65,000.00 from Realty and the simultaneous deposit of that sum in Miller Stormguard Corp. ("Stormguard"), the operating company that rented the premises owned by Realty, was in fact a "dividend" to Ned Miller, the evidence was undisputed that the appellants did not receive any money or benefit therefrom or that they intended to take funds from Realty as a dividend or for personal purposes (16a-17a, 37a).

It is material at this point to respectfully draw the Court's attention to the fact that none of the evidence produced by the plaintiffs was ever disputed or controverted by the Government. We deal here with a series of transactions engineered by Rausch who, in the course of his employment as the chief fiscal officer and trusted employee (20a-21a) of the corporations and who controlled their financial operations had engineered unauthorized transactions involving corporate funds to the extent of some $500,000.* This was not disputed by the Government. The Government now argues that the facts supporting the embezzlement were not sufficiently established. This is now like arguing that a man was not robbed because he doesn't produce the thief to admit the robbery. The fact of such manipulation was testified to by appellant

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*Rausch had no check signing authority (21a) yet Rausch drew each and every check at issue here and in addition issued and signed the $500,000 in unauthcrized checks (21a). Rausch also acted as the personal accountant for the Miller family (22a).

Ned Miller and Milton Seitman, the C.P.A. who had done the independent audit which disclosed the manipulations by Rausch (22a). The Government conducted its own audit at appellants' request. At the trial Mr. Seitman's testimoney concerning Rausch's activities or the conclusions to be drawn therefrom was never disputed by the Government. Mr. Kreps, the Government agent,supervised the audit requested by appellants (133).

If Miller or Seitman testified inaccurately, Kreps, who had audited the same books, was in a position to dispute them. He did not do so.

> "Where the evidence tends to establish a fact which it is within the power and the interest of the opposing party to disprove, if false, his failure to attempt to disprove it strengthens the probative force of the evidence tending to prove it."

Here we have the Government gibing at appellants' claim that Rausch's manipulations were at the bottom of the disputed transactions and yet, though its own agent Kreps conducted an audit on behalf of the Government of the very transactions involved in the Rausch manipulations, Kreps was never asked to testify on those very transactions! This conduct, coupled by the Government's desperate efforts to win this case on a highly questionable technical defense--a defense which resulted in the Court of Appeals imposing

an estoppel on the Government (133a), raises a very serious doubt as to the bona fides of the Government's legal position on this phase of the case.

As Judge Tyler remarked to Government counsel on the argument of the earlier appeal, "If we are going to ask citizens to cut square corners in dealing with the Government, do we not have the right to ask the Government to do likewise in dealing with its citizens?"

The Government has been dealing with less than requisite candor because throughout this case the Government has persisted in presenting and relying on an unrelated 1955 transaction in an effort to lend some credance to its position that the 1957 transaction was a dividend. It is difficult to comprehend why the Government persists in trying to mislead in dealing with the facts and the law on the issues at bar. To illustrate the foregoing in summary fashion:

In 1955 the Government maintains Stormguard, through Miller, invested $65,000 in real estate syndication in Pennsylvania.

In 1957, through a manipulation by Rausch in the course of his embezzlements, $65,000 was transferred through Miller to Stormguard. The Government does not dispute that Rausch manipulated this transaction.

The 1955 transaction is not at issue in this case. Only the 1957 transaction is at issue. Yet, the Government persistently refers to the facts involving 1955 as if they were the facts in 1957. The result is complete and utter confusion.

Illustrative of the type of misstatement involved is the following (from page 5 of the Government's first brief):

"Mr. Miller received this check [the 1957 check] which he had signed for Realty, endorsed it and deposited it in the Stormguard account." Mr. Miller's actual testimony was as follows:

> "Q All right. Now, at the time that you both signed this check and turned it over and endorsed it to the account of Miller Stormguard, did you understand that this was a repayment of the 1955 reported loan made by you from Miller Stormguard?
>
> A All I know is that Mr. Rausch told me this was necessary, but I had to sign this in order to do it. And I did whatever he told me. He was the man that made all the decisions on all the finances. (31a)
>
> * * *
>
> Q Would you answer my question?
>
> A Sir?
>
> Q Is it an accurate --
>
> A You confuse me very badly at the time.

> And all I know, is, at this point the--
> I am telling you that the man told me
> that this was a transfer of some kind,
> and that I had to do it that way. And
> I did whatever he told me to do." (33a)

There is no evidence in the record that Mr. Miller ever received any payment from Realty. The actual events were that Rausch made up a check, had Miller sign it, and deposited the check in Stormguard's account. His actual testimony concerning payment (contrary to the Government's brief) was as follows:

> "Q. I ask you again, did you in 1957 personally receive any money from 1680? [the Realty corporation].
>
> A. Never. Not through the whole life of 1680." (37a)

Another misstatement appears on page 7 of the Government's trial brief as follows:

> "The record in this case proves that the withdrawals made in 1955 and 1957 were made on a permanent basis, with no expectation of repaying that sum" (emphasis supplied).

There is no citation to the record to support such a horrendously inaccurate statement.

The extent to which the Government's brief stretches the facts and which so impressed the trial court is seen from the statement on page 12.

"In 1968, the investment (in Pittsburgh Properties) did fail, and Mr. Miller liquidated his investment in the property (Tr. 46, 73-74). Out of his $65,000 investment, Mr. Miller only received from the liquidation proceeds a few hundred dollars, and he merely commingled that money with his own personal funds (Tr. 46-47)."

Aside from the fact that the foregoing refers to the 1955 transaction which was not in issue, the actual testimony of Mr. Miller was as follows:

"Q. You received a few hundred dollars back?

A. That's about all.

Q. What did you do with that money?

A. What did I do with that money. I presume I must have kept it.

Q. I mean, in your own personal account?

A. I presume so." (34a)

It is respectfully submitted that there is a world of difference between a non-responsive presumptive answer and a statement that a party admitted that specific monies were "commingled" in a personal account.

The Government persistently deals with the facts as if the issue was "loan versus dividend." There is no such issue in this case. The persistent citation in the Government's position of "loan-dividend" decisions cannot be considered as mere oversight or innocent error.

The Government did not dispute the evidence that the entire transaction which it now claims as a technical dividend was actually part of a scheme of financial manipulation and embezzlement by David Rausch.

As a matter of fact, at the time that the Rausch transaction took place, no one knew if there were even sufficient earnings for Realty to pay a dividend--even if it wanted to. By definition, 26 U.S.C. 316 (a) (2), a dividend means a distribution out of profits or earnings and in 1957 absent books of account (there were none) and tax returns, no one knew or could know if there were earnings or profits sufficient to enable Realty to pay a dividend.

Ned Miller

Ned Miller was engaged at various times in the business of manufacturing and selling storm windows, venetian blinds and like material. He did his business through a corporation known as Miller Stormguard Corp. (15a et seq.). Stormguard occupied space in a building owned by 1680 Coney Island Avenue Realty Corporation which was a corporation also controlled by Miller, a majority stockholder.

David Rausch had been employed as the accountant for Mr. Miller, for Stormguard and for Realty.

Rausch controlled all the financial operations of Realty and Stormguard. The extent and completeness of Rausch's control of the financial affairs of Realty, Stormguard and the Millers was undisputed at the trial. (see discussion, supra.)

In 1955, 1956 and 1957 Ned Miller owned all the stock of Realty and Stormguard (16a).

In 1955 a decision was taken to have Stormguard invest $65,000.00 in a real estate syndication in Pennsylvania (Trial Transcript 27). Because Rausch told him that Stormguard couldn't be a limited partner in Pennsylvania (Trial Transcript 30), it was decided to invest in the name of Mr. Miller and the $65,000.00 came from Stormguard for that purpose.

Mr. Miller's testimony that he gave a note for the loan, paid interest thereon, and made repayments thereon (Trial Transcript 49-51) was undisputed by the Government and the transaction was never questioned by the Government.

Mr. Miller paid interest to Stormguard regularly from 1955 through 1960. In addition to interest and as far as Mr. Miller knew, he was repaying his loan.

In 1957 Rausch came to Mr. Miller with a story about the need to transfer the Pittsburgh transaction from the books of Stormguard to the books of Realty.

As it developed, Rausch's story was a complete fabrication and the conclusion is justified that it was a part of his mishandling of the corporate funds. At the trial Mr. Seitman (the transcript erroneously shows his name as "Seikman"), the certified public accountant called in to audit the corporate records when Mr. Miller became suspicious of Rausch (21a et seq.), explained the transaction as recorded by Rausch on the books of Stormguard (42a et seq.). Rausch's peculations had left Stormguard very short of cash. When Rausch got the $65,000.00 from Realty, he deposited it into Stormguard's general funds and issued on the books (but didn't deliver)a check to Miller for $65,000.00. In effect Rausch treated the transaction as an exchange between the two corporations as if Miller didn't exist. That check was never signed and was found years later floating in one of Rausch's drawers. The check was entered as if it had been delivered and negotiated. As a result when he had told Miller that the loan from Stormguard had to be replaced, Rausch actually handled the transaction as an exchange on Stormguard's books (48a et seq.) It is reasonable to conclude at this juncture that Rausch's story to Miller was part of his scheme to replace the shortage of funds in Stormguard.

By telling Miller the fanciful story he did, Rausch withdrew money from Realty. Thus, Stormguard had $65,000.00

in needed cash, the Miller loan remained on the Stormguard books unpaid and Miller remained unaware of Rausch's misconduct because Stormguard continued functioning as if all was well -- something it couldn't have done if Miller had been told it was short of cash.

About Labor Day, 1962, Miller became suspicious of Rausch and called for an audit of the books by an independent auditor, Milton Seitman. Although Rausch did not have a signature on the general accounts of Realty and Stormguard, the audit disclosed that $500,000.00 in unauthorized checks had been issued by Rausch (21a). It was discovered that Realty's income tax returns had never been filed (22a).

Mr. Miller instructed Mr. Seitman to bring the matter to the attention of the I.R.S. Following the I.R.S. audit, the agent, Mr. Kreps, declared the $65,000.00 issued by Realty and deposited in Stormguard's bank account in 1957 to be a dividend and assessed the tax thereon. (23a)

It has never been disputed that none of the $65,000.00 from Realty ever went to the appellants.

Milton Seitman

Mr. Seitman testified that it was Mr. Miller who directed that I.R.S. be brought into the matter (Trial

Transcript 69(and that Mr. Kreps was the I.R.S. agent who conducted the audit.

Mr. Seitman testified that the only basis for the determination by Mr. Kreps that the $65,000.00 issued by Realty was a dividend to Mr. Miller was the fact that it was made payable to Mr. Miller (56a). Mr. Kreps then disallowed the interest paid by Mr. Miller to Stormguard for the two years following 1957 (58a) on the theory that the $65,000.00 repaid the Stormguard loan (although there was no book or record basis for such a conclusion.) In fact the books actually reflected an exchange leaving the original loan on the books (50a).

The Government produced neither documents nor witnesses to dispute the testimony of Mr. Miller or Mr. Seitman.

The Issue Presented

Where the taxpayer and his accountant give a valid and credible and undisputed explanation of a transaction, can the trier of the fact ignore that explanation and draw some contrary suppositious conclusion in the absence of any evidence to support such a contrary conclusion?

Argument

The trial court erroenously dealt with the transaction as if appellants first withdrew the $65,000 from Realty and then independently decided to place that sum to repay a so-called "loan" from Stormguard to appellants. The Government fostered this view even though it was inconsistent with the Government's own argument for the trial court's error gave the Government the assessment it wanted. Whether there was a dividend in fact or only a transaction in the course of Rausch's peculations was an issue to be determined by the trial court to help determine whether the taxpayers were being dealt with fairly. The trial court ignored this fundamental issue and yet this was the key issue. The Government used the Stormguard books to demonstrate an underlying loan to

appellants. The trial court leaves the impression that there was a time lag between the issuance of the Realty check and the deposit of that check into the Stormguard account. There is no evidence in the record to support such a finding. As a matter of fact, the evidence is to the contrary. The books demonstrated that the loan remained unpaid long after the so-called Realty dividend was allegedly received by the appellants and those same books showed that the so-called "dividend" was received by Stormguard simultaneously with its issuance by Realty. The trial court ignored all of the foregoing.

All the trial court did was assume that Miller was the prime actor with Rausch, a mere facilitating employee. This was a concept that not even the Government advanced and rendered the trial court's decision as being based on evidence not in the record and not contended for by either side. The trial court did not and could not dispute the Miller and Seitman testimony from the record.

Although the Government in its brief has seen fit to carp at the evidence given by Mr. Miller and Mr. Seitman, it has never shown why the rule in 32A C.J.S. Par. 1038 should not be controlling here. As stated in C.J.S., at page 728:

"Uncontradicted or undisputed evidence should ordinarily be taken as true. (citing cases in too many jurisdictions to detail) More precisely, evidence which is not controverted by positive testimony or circumstances, and is not inherently improbable, incredible or unreasonable cannot be arbitrarily or capriciously discredited, disregarded or rejected, even though in a particular case the witness is a party or interested person; and, unless such evidence is shown to be untrustworthy, it is to be taken as conclusive, and binding on the trier of the facts, or, at least, it is entitled to and must be accorded substantial weight." (emphasis supplied)

* * *

continuing in C.J.S. at page 735:

"Where the evidence tends to establish a fact which it is within the power and the interest of the opposing party to disprove, if false, his failure to attempt to disprove it strengthens the probative force of the evidence tending to prove it."

POINT I

The Basic Error In the Trial Court's Holdings Lay In It Adopting The Appellee's Argument That A Transaction Which Is Not A Loan Must Be A Dividend. Thus, the Trial Court's Decision Was Not Based On The Facts In Evidence, But On An Argument Disputed By The Actual Evidence. The Trial Court Advanced Completely Erroneous Statements As Facts And The Findings By The Trial Court Do Not Merit Acceptance On Review.

A. The only issue was whether the 1957 transaction in issue constituted a dividend. That issue could not be decided on the basis of the facts involved in a 1955 transaction, and the trial court reversibly erred in doing so.

B. In deciding as it did (Part 1A *supra*) the trial court made no independent fact finding of its own as required by Rule 52, F.R.C.P., but adopted an argument of appellees as its finding of fact.

C. The 1955 transaction upon which the trial court relied so heavily was never in issue and was never pleaded to or otherwise made part of the issue in litigation. It was used as an explanatory argument by the Government, but neither side offered any evidence on the true nature of that transaction.

D. By completely ignoring the Rausch issue the trial court actually decided the case on issues that were not before it.

The key concept advanced by the trial court was the holding that a transaction between a stockholder and a corporation which is not a loan must be a dividend.

The actual fact situation was that Rausch, in the course of his manipulations, induced Miller to consent to a withdrawal of $65,000 for transfer to Stormguard. This is exactly what occurred and this was what the trial court realized and found that Rausch did, infra. Rausch drew the check to Miller who signed it and returns it to Rausch. The check itself was endorsed for deposit into Stormguard's account. Miller received no benefit, direct or otherwise, from the transaction (37a). The essentiality of benefit as expounded in the Rushing case is ignored by the trial court (see Part IV infra.)

As readily as the trial court confused the Realty transaction with Miller (see discussion, infra,)so did the trial court confuse the nature of the 1955 Stormguard transaction. Speaking of that transaction the trial court, at one point, says:

> "The record indicates that Mr. Miller did not intend to repay the $65,000 which Realty paid to him. et seq."

Mr. Miller's actual testimony as as follows:

(Tr. Tr. 50-51, 36a)

"By Mr. Feldman (on redirect):

" Q. Reading again from page 18:

'Question: At the time you made this loan and signed the note and the letter of June third, 1955 what was your understanding as to how long this note was beginning to remain outstanding?

'Answer: Well, I had hoped to pay it off in a few years at the most. In fact I did make payments back from time to time. He asked me for money and I gave him monies.

'Question: Did you make the payments of the principal on this loan?

'Answer: I gave him everything he asked me. He asked me for monies on account. At one time I even took a cashier's check from the bank for a substantial sum of money and I gave it to him. I presume that this was paying off my account."

The basis on which the trial court found that "Mr. Miller did not intend to repay the $65,000 which Realty paid to him." remains a mystery so far as the record is concerned.

This learned court is respectfully referred to the justification advanced by the trial court in an attempt to sustain the holding of dividend and the trial court made no finding of direct benefit to Miller. (Please see Point IV, infra.)

"The crucial concept in a finding that there is a 'constructive' (sic) dividend is that the corporation has conferred a benefit on the stockholder in order to 'distribute' (sic) available earnings and profits without expectation of repayment." What the benefit to Miller

was is nowhere defined or set forth in the trial court's opinion or so-called findings.

Faced with the inability to identify a specific benefit to Miller (and faced with the Government's unsupported claim that the so-called dividend was used to pay off a loan, the trial court made the following curious finding: "Although Stormguard's books do not indicate (contrary to the Government's claim) that the Realty check repaid Mr. Miller's loan, these book entries [made by Rausch] are merely evidentiary rather than controlling" [emphasis supplied].

* * *

The trial court went on, "Mr. Miller, the chief executive officer of both Realty and Stormguard, clearly intended to have the Realty check discharge his obligation to Stormguard (Trial Tr. 33)" Not only was there no such intent, but no such testimony by Mr. Miller. Mr. Miller actually testified as follows:

> "You (referring to Government counsel) confuse me very badly at the time. And all I know is, at this point the -- I am telling you that the man (Rausch) told me that this was a transfer of some kind, and that I had to do it that way. And I did whatever he told me to do." (33a)

This testimony which the trial court saw fit to ignore referred to Rausch's story to Miller that the I.R.S. required that the initial Stormguard transaction be replaced by Realty. Yet the trial court found that the Realty check to Miller was a loan (118a, see discussion, infra)*. Even the trial court realized that Rausch's manipulations did not include repayment of the Stormguard loan. As the trial court said:

> "Although the 1957 Realty check was intended by Miller to discharge his outstanding indebtedness to Stormguard, Rausch failed to give Mr. Miller credit for the Realty check on Stormguard's books; * * *" (119a)

It is significant at this juncture to bear in mind that the Government never contended that the 1955 Stormguard transaction with Miller was anything other than a loan and raised no question with regard thereto. As a matter of fact, the trial court, in describing the transaction, in speaking of the transfer from Realty to Stormguard, said the following:

> "Mr. David Rausch, who through the period in question was in charge of financial matters at Stormguard and Realty, told Mr. Miller in 1957 that Mr. Miller's loan from Stormguard would have to be replaced by a loan to Mr. Miller from Realty." (118a emphasis supplied)

The question immediately suggests itself: If the trial court

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*The trial court's decision shows the domination that Rausch exercized over these transactions.

found that the Realty-Miller transaction was a replacement loan, how can it simultaneously be a dividend chargeable as taxable income to Miller? Neither the trial court nor the Government either attempted to or did reconcile the impossibility of one and the same transaction being simultaneously a loan and a dividend.

The issue in the case at bar is whether a 1957 transfer by Realty of $65,000 to Stormguard was a dividend to Miller? Manifestly a dividend would have to show Miller's receipt of the money, and, when made, a benefit to Miller. The trial court, instead of finding the foregoing, found that the transaction was a so-called "loan replacement".(118a)

There cannot be a "loan replacement" which would mean that Realty would become the lender to Miller as borrower, and at the same time have the same transaction be a dividend, which would mean that no loan could exist -- whether as replacement or in any other fashion. The trial court has never made any fact findings explanatory of its inconsistent holdings that the $65,000 in question was both a dividend and a loan replacement!

Curious as well is the trial court's bland treatment of Rausch's position in this entire transaction. The trial court speaks of Rausch as if he was a mere bookkeeper

instead of the manipulator that he actually was. As a matter of fact and against the Miller and Seitman testimony that Rausch dominated the Miller-Realty-Stormguard financial operations [testimony undisputed by the I.R.S. agent Mr. Kreps] the trial court deals with the matter as if it was directed by Miller with Rausch, the innocent amanuensis -- the only way in which the trial court could reach its ultimate conclusions.

POINT II

The Evidence That The 1957 Transaction Was Not A Dividend Is Clear and Undisputed And The Cases Relied On By The Government Do Not Support Its Position.

The involvement of the I.R.S. in the affairs of Realty was solicited by Miller as a result of the discovered manipulations by Rausch. The fact that $500,000.00 in unauthorized checks were issued by Rausch was not disputed by the Government. Certainly if Rausch's conduct was not as claimed, the audit by Mr. Kreps, the I.R.S.' own man, would have disclosed that fact. That Mr. Kreps chose to ignore Rausch's conduct so that he could make the technical charge of a dividend does not change the fact that the transaction at issue was directly involved in the course of Rausch's manipulations. The fact that this transaction was induced by an undisputed falsehood "the replacement story" by Rausch cannot be ignored.

What sense was there to the entire transaction except to replace funds in Stormguard that had been drained by Rausch's manipulations? So far as Miller was concerned he owned both corporations. If he took money from one corporation and placed it in another, his own asset picture didn't change and his doing so didn't benefit him even indirectly.

Where defalcations are involved the courts look to substance not to form. Rausch dominated the financial activities of Realty and Stormguard. Because he needed Miller's signature on the Realty check of $65,000.00 he lied to Miller and he lied in the course of his manipulations.

As was held in Dobyns-Taylor Hardware Co., Inc. v. U.S., 278 F. Supp. 538 (a tax refund case):

> "In such case the courts will not permit themselves to be blinded and deceived by mere forms of law, but, regardless of fictions, will deal with the substance of the transaction involved as if the corporate agency did not exist and as the justice of the case may require.*** 'Chicago, M. & St. P.R. Co. v. Minneapolis C & C. Asso. (1918), 247 U.S. 490, 501, 38 S. Ct. 533, 62 L. Ed. 1229, 1237.'"

The court then went on:

> "*** 'A corporation will be treated as a distinct legal entity, ordinarily, and until proof is adduced to the contrary. But that notion will not prevail when the result would be to give countenance and effect to mere sham and work injustice.'*** "N.C. & St. L. Ry v. Faris (1932), 166 Tenn. 238, 244 (1), 60 S.W. (2nd) 425, 427. ***Whether a subsidiary corporation is not to be considered a separate entity 'cannot be asked or answered, in vacuo'***; the issues in each case must be resolved in the light of the policy underlying the applicable legal rule, whether of statute or common law."

POINT III

The Trial Court Erred In Holding That The Only Possibilities Were Loan or Dividend.

By citing only loan-dividend cases, the Government seemingly has successfully controlled the trial court's view of all the evidence at bar.

Chattanooga Savings Bank v. Brewer, 17 F. 2d 79, cert. den. 274 U.S. 751 involved a motion for summary judgment and the basic question there was whether there was an issue of fact. It is not dispositive of any of the issues in the case at bar.

Roschuni v. Commissioner, 29 T.C. 1193 (Doc. #58161) aff'd 271 F. 2d 267 does not stand for the proposition advanced for it by the Government. As a matter of fact, it supports plaintiffs' argument that all the underlying factors (Rausch, etc.) must be considered before any conclusion can be drawn. As the court there stated, at page 1201:

> "Whether withdrawals from a corporation represent loans or taxable distributions depends on all the facts and circumstances surrounding the transactions between the stockholders and the corporation. Harry E. Weise, 35 B.T.A. 701 (1937), aff'd. 93 F. 2d 921 (C.A. 8, 1938), certiorari denied 304 U.S. 562 (1938), rehearing denied, 304 U.S. 589 (1938); W.T. Wilson, 10 T.C. 251 (1948)."

Chesapeake Manufacturing Co. v. Commissioner, T.C. 23 T.C.M. 1284, aff'd 347 F. 2d 507 involved an inactive non-employed stockholder who received "loans" from a corporation and who was actually receiving dividends.

Tollefsen v. Commissioner, 431 F. 2d 511, favors the plaintiffs' view of the evidence for it holds:

> "The primary factual determination is recognized to be the intention of the sole-shareholder of the corporation at the time the transfer is made--Wiese v. Commissioner of Internal Revenue, 93 F. 2d 921 (C.A. 8th, 1938), C.I.R. v. Makransky, 321 F. 2d 598, 600 (3 Cir. 1963). To carry the burden imposed upon him the taxpayer must prove by a preponderance that he had a state of mind at the time of withdrawal which included a specific plan to use the money solely for the corporation's business. A vague, uncertain or indefinite intention as to repayment or use for corporate purposes at some time in the future is insufficient where the withdrawal places the money in the taxpayer's absolute control and subject to his absolute discretion as to its use" (emphasis supplied).

In the case at bar Mr. Miller never had absolute control or absolute discretion over the $65,000 that was transferred to Stormguard in 1957.

Makransky v. Commissioner, 321 F. 2d 598, involves a third-party beneficiary payment made to discharge the taxpayer's estate tax liability.

Regensburg v. Commissioner, 144 F. 2d 41 involved a family's dealing with corporate earnings.

Wiese v. Commissioner, 93 F. 2d 41 Cert. den. 304 U.S. 562 held that the mere fact that a corporation has undistributed profits doesn't mean that a loan to a stockholder is a dividend.

Chism v. Commissioner, 322 F. 2d 956 emphasizes the degree of care which must be paid to all the surrounding circumstances in cases of this type.

Clark v. Commissioner, 266 F. 2d 698 emphasizes the significance of Chism as follows:

> "Whether a withdrawal is a loan is a factual question to be determined upon consideration of all the circumstances present in a particular case, and depends upon the existence of an intent at the time the withdrawal is made that it should be paid back. Wiese v. Commissioner (1938) 8 Cir., 93 Fed. (2d) 923 [38-1 USTC paragraph 9659] c.d. 304 U.S. 562; Estate of Isadore Benjamin (1957), 28 T.C. 101, CCH 22, 340; Estate of Helene Simmons (1956), 26 T.C. 409, 423 (CCH Dec. 21, 764]; Carl White (1952), 17 T.C. 1562, 1568 [CCH Dec. 18, 856]; 1 Mertens, Law of Federal Income Taxation, Sec. 921. Upon all the facts found here, though individually they might not support the conclusion, we find the tax court's conclusion that the withdrawals were dividends is not clearly erroneous."

Taschler v. U.S. 440 F. 2d 72 again emphasizes the absolute necessity to consider all the surrounding circumstances. Here the Government sought and the trial court decided to ignore the Rausch facts. Contrary to the Government's brief, Taschler doesn't even remotely resemble the case at bar.

Botany Worsted Mills v. U.S. 278 U.S. 282 does not deal with dividends or loans. It deals with the deductibility of certain extraordinary, unusual and extravagant withdrawals taken as expenses. The rule that a taxpayer has the burden of proving the deductibility of his expenses offers no enlightenment on the question of whether the 1957 transaction

was a loan or a dividend.

Gurtman v. U.S. 237 F.S. 533 deals with a situation in which the taxpayer claimed, but could not prove, that the transactions were loans. There is no such issue in this case. Miller has never claimed that the Realty withdrawal was a loan.

Taschler v. U.S., 440 F. 2d 72, cited with irrelevant enthusiasm by the Government also relates to a claim by the taxpayer that the withdrawals were loans. The fact that Taschler bears no resemblance to the case at bar is made obvious when one compares the taxpayer's control of the corporation in Taschler to the lack of control had by plaintiffs here-- where Rausch controlled the situation. In Taschler the court found that:

> "The evidence in the cases clearly shows that Mr. Taschler handled the corporate funds as his own and withdrew sums at will as needed by him with no real intention of ever repaying the monies to the corporation."

The foregoing factual situation is so remote from the case at bar as to make one wonder at the degree of responsibility to be accorded to the Government's brief.

> "When a shareholder removes funds from a corporation using those funds for his own uses,* and subjects the repayment of those funds to

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*Here is yet another instance of a factual statement without any citation to the record to support it.

'risk of loss', then 'by no stretch of the imagination' (sic) could that withdrawal be a 'loan'."

The foregoing statement is about as silly a statement as any in the Government's brief. In effect, the Government argues, no one ever borrows money to make a bad investment! Would that this were true.

In any event, plaintiffs have never asserted that the 1957 transaction was a loan. This comes only from the imagination of the author of the Government's trial brief. It certainly doesn't come from the record. Plaintiffs have always claimed the transaction to be one arising out of an embezzlement.

In the absence of any claim by plaintiffs that the 1957 transaction was intended to be a loan, the position taken by the trial court is clearly inapplicable.

Tollefsen v. Commissioner supra, is not on all fours with the case at bar. The two cases are not even kissing cousins. The case at bar involves a transaction in the course of a third party embezzlement. None of the cases cited by the Government even begin to approach such a factual situation.

POINT IV

The Government's Argument That A Withdrawal Which Is Not A Loan Must Be A Dividend Is Not Supported By Prevailing Authority

Throughout its opinion, the trial court couples the loan concept with the dividend concept until the ultimate reaction is that the trial court seems to be contending that if a transaction is not a loan, it must be a dividend. Such a concept is illogical and not supported by existing authority.

Undisputed, and the trial court recognized, is the evidence by Mr. Miller of Rausch's story as compelling the transfer of funds from Realty to Stormguard to satisfy an alleged IRS requirement. Manifestly it was Miller's intent, in relying on Rausch, to effect a proper corporate purpose. The rule is stated thus in Nasser v. U.S. 257 F. Supp 443 at 447: Aff'd 301 F. 2d 243, (Cert. Denied) 370 U.S. 923.

> "In this case the ultimate issue is whether certain transfers of corporate money to plaintiff taxpayer constituted dividend income to him under the Internal Revenue Code. The legal characterization of these transfers under standards defined by federal law is the ultimate issue for decision. "Chism's Estate v. Commissioner of Internal Revenue, 322 F. 2d 956, 960 (9th Cir. 1963), United States v. Loo, 248 F. 2d 765 (C.A. 9th 1957). Specifically at issue is the question of whether the 'transfers' or 'with drawals' in 1960 and 1961 were 'distributions' within the meaning of Section 61 and Section 316(a) of the Internal Revenue Code (26 U.S.C. 1964 ed.) and therefore taxable as dividend income, or

> whether the funds were transferred to plaintiff to be used by him as an investment agent on behalf of the corporation for its purposes and therefore not a dividend. Mertens Law of Fed. Inc. Tax Section 9.23."

The original 1955 transaction was to make a corporate investment. Rausch informed Miller that Stormguard could not be a limited partner in Pennsylvania. When, later, Rausch came up with the story that the funds had to originate with Realty not with Stormguard (Rausch attributed this requirement to I.R.S.) and Miller, trusting Rausch, went along, there was no change in Miller's intent. It was not to take a dividend, but to effect a proper corporate purpose, i.e. the investment of excess funds.

The Government never disputed the business purpose of the transaction. As stated in Kessner v. Commissioner 26 T.C. 1046, aff'd 248 F. 2d 943:

> "Thus our principal concern is whether the net effect of a transaction, absent a real and substantial business reason on the part of the corporation as distinguished from a purpose to benefit the shareholders, was to distribute accumulated earnings and profits among the shareholders the same as if a cash dividend had been declared and paid."

In the case at bar there was no evidence that the purpose of the Realty transaction was to distribute accumulated earnings and profits. When Rausch advanced his phony reason so as to get cash from Realty into a depleted Stormguard,

Miller had no way of knowing whether there were accumulated earnings or profits available in Realty for distribution among the shareholders. Rausch's concern was to hide Stormguard's parlous condition from Miller.

It is respectfully submitted that there is no validity whatever to the repeated assertion that if the transaction was not a loan, it had to be a dividend. The authorities have shown that a transaction can be neither loan nor dividend.

In the transaction at issue all that happened was that money was transferred from Realty to Stormguard. There was no benefit to Miller. The conferral of "benefit" is the standard which the courts seek to establish before reaching the conclusion of dividend or not. As was stated in Rushing v. Commissioner, 52 T.C. 888, at page 894:*

> The fact that Rushing was the sole shareholder of both L.C.B. and Briercroft is not a sufficient basis for concluding that Rushing constructively received the advances of L.C.B. Although Rushing dominated Briercroft as its single shareholder, we must recognize that Briercroft was a taxable entity separate from Rushing. Best Lock Corporation, 31 T.C. 1217, 1237 (1959(. We have decided that whatever personal benefit, if any, Rushing received was derivative in nature. Since no direct benefit was received, we cannot properly hold he received a constructive dividend." (emphasis supplied)

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*The Rushing decision quite clearly rejects the constructive dividend theory advanced by the trial court here.

It is respectfully submitted that no dividend was involved in this case and plaintiffs are entitled to an adjudication on the equities and the actual facts.

CONCLUSION

It is respectfully submitted that the findings of fact as made by the trial court fail to meet the requirements of F.R.C.P. 52(a) and hence the judgment of dismissal must be reversed. It is further submitted that on the basis of the evidence adduced at the trial judgment in favor of appellants should be granted and reimbursement of the tax payment, along with interest, should be made to appellants.

Respectfully submitted,

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IRVING FREDERICK, of counsel
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APPENDIX

FEDERAL RULES OF CIVIL PROCEDURE

Rule 52.

FINDINGS BY THE COURT

(a) Effect. In all actions tried upon the facts without a jury or with an advisory jury, the court shall find the facts specially and state separately its conclusions of law thereon, and judgment shall be entered pursuant to Rule 58; and in granting or refusing interlocutory injunctions the court shall similarly set forth the findings of fact and conclusions of law which constitute the grounds of its action. Requests for findings are not necessary for purposes of review. Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses. The findings of a master, to the extent that the court adopts them, shall be considered as the findings of the court. If an opinion or memorandum of decision is filed, it will be sufficient if the findings of fact and conclusions of law appear therein. Findings of fact and conclusions of law are unnecessary on decisions of motions under Rules 12 or 56 or any other motion except as provided in Rule 41(b).

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 301. DISTRIBUTIONS OF PROPERTY.

(a) In General. -- Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

(b) Amount Distributed.--

1. General Rule.-- For purposes of this section, the amount of any distribution shall be--

(A) Noncorporate distributees.-- If the shareholder is not a corporation, the amount of money received, plus the fair market value of the other property received.

(B) Corporate distributees.-- If the shareholder is a corporation, the amount of money received, plus whichever of the following is the lesser:

(i) the fair market value of the other property received; or

(ii) the adjusted basis (in the hands of the distributing corporation immediately before the distribution) of the other property received, increased in the amount of gain to the distributing corporation which is recognized under subsection (b) or (c) of section 311.

(c) Amount Taxable -- In the case of a distribution to which subsection (a) applies--

(1) Amount constituting dividend.-- That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

(2) Amount applied against basis.-- That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.

SEC. 316. DIVIDEND DEFINED.

(a) General Rule.--For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders--

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the

earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

SERVICE OF 2 COPIES OF THE WITHIN

Appellants' Brief

IS HEREBY ADMITTED.

DATED:

Attorney for

UNITED STATES ATTORNEY
FEB 19 11 19 AM '76
EASTERN DISTRICT
OF NEW YORK

Sylvia E. Moore

STATE OF NEW YORK
COUNTY OF NEW YORK

EDWARD TAYLOR being duly sworn deposes and says: On February 19th, 1976 I served the within ~~record on appeal~~ brief ~~appendix~~ on Assistant Attorney General Scott P. Crampton ~~the attorney for the respondent~~ by ~~leaving~~ mailing ~~two~~ three copies thereof ~~to~~ at his office located at Tax Division Department of Justice Washington, D. C. 20530

Edward Taylor

Sworn to before me
this 19th day of
February 1976

Rose Goldman

ROSE GOLDMAN
COMMISSIONER OF DEEDS
CITY OF NEW YORK 2-555
Certificate filed in New York County
Commission Expires July 1, 1977.